The Enlargement of the European Union: The impact of joining the Single Market

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With accession negotiations between the EU and the Central and Eastern European countries entering the final stages, increasingly more attention is being given to the likely economic effects of joining the Union. The wider public as well as economic and political elites in the accession countries are debating the potential impact of becoming part of the world's largest market without internal barriers. This article addresses the implications of joining the Single Market for the accession economies. Most of the examples provided here are based on the analysis undertaken in Lithuania, but its insights can be generalized to other candidate countries.

The approaching conclusion of the accession negotiations (by the end of this year under the Danish presidency, as many hope) and the accession itself (by 2004) is naturally creating interest in the economic effects of the EU enlargement, this should not obscure the fact, that the integration of the applicant countries and the EU has been taking place for about a decade. This means, that the accession itself is not likely to bring any sudden changes, because the process of integration is a gradual one. It started with the removal of barriers to trade in the beginning of the 1990s, and it will continue after the EU enlargement with some transition periods extended for some of the "four freedoms" and with further integration taking place inside the Union. Still, even taking into account the gradual nature of economic integration in Europe, the enlargement of the EU is likely to have important implications for the economies of both the current and future member states.

The dual challenge of competition and regulatory adjustment

The economic impact of EU accession for the economies of the candidate countries could be characterized as a dual challenge of increasing competition and adjusting to the higher regulatory standards, which are in force in the EU Single market. The accession into the EU could be seen as a process during which (1) the barriers to exchange of goods, services and factors of production between the EU and the candidate countries are removed and (2) common policy principles and norms of behaviour are adopted (by the candidate countries).

The removal of barriers to trade results in an increased access to the new markets and therefore creates new opportunities for companies to expand their activities beyond the national borders, provides consumers with a wider range and a better quality of products and services. It also creates conditions for the growth of competition after the import duties, quantitative restrictions and physical barriers to trade are removed. It is the increase of competition which is going to bring the most significant benefits to the economies of the candidate countries (and current member states) by strengthening incentives to improve the productivity, exploit the business opportunities by specialization and division of labour in the Single Market. Although the parallel nature of economic (transition) reforms in the candidate countries and the introduction of integration measures complicates any quantitative estimates of economic benefits of integration, there is a strong agreement about the significance of these effects.

The other group of integration measures includes the adoption of the norms and policy principles (the so called acquis communautaire) by the candidate countries. The enlargement is based on the more or less consistently applied rule which states that the candidate countries have to transpose and enforce the norms and principles which are applied in the EU. Taking into account that the EU is much more than the free trade area, accession of Central and Eastern European countries also include the alignment of external trade regime (including the adoption of the EU common external tariff), the adoption of product and process standards (ranging from quality standards of toys, pharmaceuticals, electronic equipment, etc. to safety at work and environmental norms), and application of other EU common policies (common

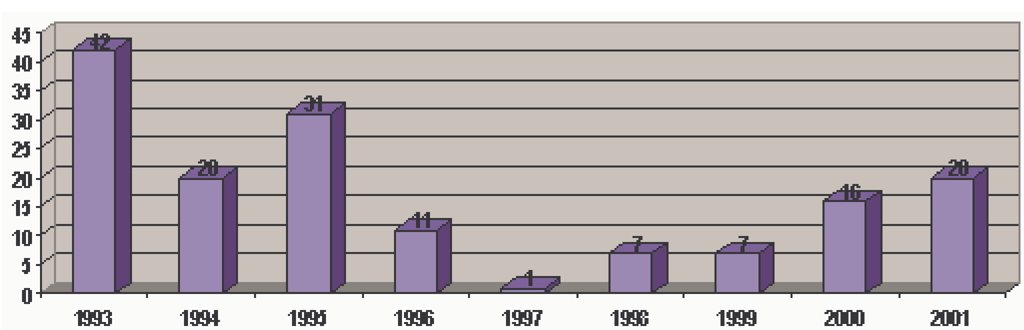
agricultural policy, transport policy, regional policy, etc.). The effects of adopting these measures on the economies of candidate countries depend on the nature and degree of adjustments to the acquis as well as the level of integration already achieved.
The impact of joining the Single market, thus, can be analyzed by further detailing the effects of removing barriers to trade and movement of factors of production on the one hand, and adoption of common EU standards on the other hand. Of course, this distinction is not always clear cut, since the removal of non-tariff barriers to trade is often linked to the adoption of product standards (for example, only those diary producers in candidate countries which are certified on the basis of meeting EU norms can export their products to the Union). But this distinction (which is sometimes also referred to as negative and positive integration) provides important insights into the nature and the impact of integration in Europe.

From ”free trade” to ”four freedoms”

As mentioned the gradual process of economic integration between the EU and the candidate countries started in the beginning of the 1990s, when the first agreements on liberalization of trade were signed. For the Visegrad countries (Hungary, The Czech Republic, Slovakia and Poland) , these were the association agreements and in particular the ”interim agreements” that removed the barriers to trade in industrial products. The Baltic states soon followed with the free trade agreements that were signed with the EU in July 1994 and came into force in 1995. On the basis of these agreements, the EU removed import duties from the beginning of 1995, while each Baltic state had a different schedule of liberalization with Estonia applying the tariff free regime, Latvia having a four year transition period and Lithuania – a six year period, during which the import duties were gradually removed. These agreements were later incorporated into the association agreements which were signed between the Baltic states and the EU in June 1995 and came into force in February 1998.

The liberalization of trade with the EU together with general external liberalization undertaken by the Central and Eastern European countries in the beginning of the 1990s proved to be a major factor in creating conditions for economic recovery and growth. The trade flows between the applicant countries and the EU have been rising throughout the decade. Even in the case of the Lithuania, which was most affected by the Russian economic crisis in 1998, and with national currency litas until February 2002 being pegged to the US dollar against which euro depreciated in 1999-2000, the growth of trade with the EU has not reversed.

Growth rate of Lithuania’s exports to the EU, %



Source: Lithuanian Department of Statistics

It should be noted that the growth of Lithuania’s exports has exceeded the growth of EU’s imports for all the years except 1997. The share of foreign trade to the country’s GDP has increased significantly, in particular during the first half of the 1990s. In 2000, the foreign trade as a share of GDP equalled about 71 percent for Latvia, about 82 percent for Lithuania and reached 179 percent for Estonia. The Baltic states have soon become the most open economies of all the candidate countries with Estonia applying no import duties and Latvia and Lithuania having comparatively low tariffs, in most cases lower than the ones applied by the EU.

The share of the EU-oriented exports has also been increasing in the foreign trade turnover of the candidate countries.

The share of the EU-oriented exports in country's total exports, %

	1994	1995	1996	1997	1998	1999	2000	2001
Estonia	47,9	54,7	51,0	48,6	55,1	62,8	68,5	n.a.
Latvia	39,3	44,2	44,1	48,8	56,6	62,6	64,6	n.a.
Lithuania	30,1	36,4	33,4	32,5	38,0	50,1	47,9	47,8

Source: World Bank, Lithuanian Department of Statistics

The economic trade links have been paralleled by the growing foreign direct investment. Currently, more than 70 percent of FDI in the Baltic states originates from the EU, in particular the Scandinavian countries. Significant shares of foreign investment were attracted through privatization, in particular in infrastructure and financial services. Business networks have also been developing through outsourcing and subcontracting which link products of furniture, electronics and other producers in the Scandinavian EU members and the Baltic applicant countries. The proliferation of the free trade agreements between the EU, Baltic States, the CEFTA and EFTA which were all driven directly or indirectly by integration into the EU has contributed significantly to the expansion of trade and business networks in the Baltic Sea region.

However, the liberalization of trade between the EU and the candidate countries has been both gradual and selective. The EU has reserved the right to apply commercial protection instruments which until now have been restricting trade with its partners. For example, several Lithuanian producers have experienced the negative effects of the antidumping duties imposed by the EU. The agricultural trade is another area where trade liberalization has been very slow. It is still restricted by customs duties and non-tariff barriers which will probably be removed only upon the accession into the EU.

Therefore, although the candidate countries are already considerably integrated into the EU on both levels of informal economic relations (business contracts) and political contacts (negotiations, consultations, information sharing and monitoring of the membership obligations), the additional benefits will accrue after joining the Single market. These will include the removal of remaining market protection measures and the physical barriers to trade and movement, namely, the customs procedures. The latter are in particular important for reducing the transaction costs of businesses. According to some estimates, the costs of customs procedures currently make up around 3 percent of the exports' value.

The immediate benefits would result from the removal of the remaining barriers to trade, while long term benefits to the accession economies would come from increase in competition, removal of barriers to the free movement of capital (restrictions to sales of agricultural land) and labour (discriminatory employment regimes). The latter two areas are the ones where some candidate countries (though not the Baltic states) and some EU member states intend to apply transition periods. The full membership in the Single Market would most likely generate additional trade, foreign investments and economic growth in the new member states, the more exact estimates of which differ between 1.5 to 19 percent of GDP depending on the reduction of risk premium and the effects of removing barriers to trade.

It should be remembered, that joining the EU will imply the adoption of the Union's external trade policy which might have diverse impact depending on the nature and degree of change. For example, for Estonia with its liberal foreign trade policy the adoption of EU common external tariff will increase the level of protectionism and would probably result in some trade diversion. For Poland, which has relatively more protectionist policy than the EU, the alignment of import duties will produce economic benefits.

For Lithuania, which applies an average 2.5 percent of import duties for industrial products which is lower than the EU average of 4.5 percent, there will be some trade diversion. According to the study done by the Lithuanian Ministry of Foreign Affairs, if the EU import duties were adopted in 2000, the imports of industrial goods would become more expensive by about 90 million litas ((Litas was pegged to the euro at a fixed exchange rate of 3,45 litas to 1 euro from February 2002. Before that Litas was pegged to the US Dollar.), while the lowering of import duties would bring a decrease of only about 11 million litas. This means a general increase in protection, although the total effects are likely to be insignificant since about 70 percent of Lithuania's trade already takes place on the basis of free trade agreements. The import duties would affect trade with Russia, USA, Belorussia and Japan most.

The effects of regulatory harmonization

Most of the attention in the candidate countries is currently directed at transposition and enforcement of EU norms. Some of them, for example health and safety at work are fully transposed into the national law in most candidate countries. The adoption of others, for example environmental, energy, agricultural norms, will extend beyond the date of accession. Most of them will require companies in the accession countries to adjust their practices to the new rules of the game. Several observations could be suggested regarding the effects of adjustment to the new rules of the game.

The companies which will be most affected by the need to invest into the higher product and process standards are small and medium sized enterprises which produce for the local market or import from the CIS. These are the companies which will face the highest adjustment costs and will have to accumulate additional investments. This process is likely to be handled by initiating mergers (as it has been the case in the diary or pharmaceuticals sector in Lithuania in recent years) or inflows of foreign investments (or the closure of the activities altogether). In this context, the regulatory environment of starting new businesses and the ease of market entry will be of particular importance in order to easy the adjustment of small business to the new regulatory standards. However, the investments into the new standards are likely to translate into higher prices, which in some cases like in the pharmaceutical sector are estimated to increase by up to 30 percent.

On the other hand, large companies from the accession countries which already operate and sell in the EU market will have additional benefits from the actual accession into the EU. In the case of Lithuania, these include road haulage carriers, companies producing furniture, fertilizers, electronics, textiles and diary products. They will accumulate savings from removal of customs procedures and setting up of certification centres in their domestic markets, from removal of a threat of potential introduction of market protection instruments by the EU, from uniform rules and economies of scale. In such a way, the competitiveness of companies in the candidate countries due to their natural advantages and new opportunities in the Single market will be strengthened. Moreover, investors from other EU member states and third countries could take advantage of these new opportunities which would also benefit accession economies.

Competitiveness through enlargement

The impact of EU accession on the candidate economies will depend on the nature of concrete business and in particular on the extent of their current internationalization. While the membership in the Single Market is likely to generate additional economic benefits for the candidate countries, it would from the candidate countries point of view be rational to extend transition periods to the adoption of EU acquis which requires significant investments.

It is important to notice that the progress in following the timetable of the accession negotiations and the enlargement will become the crucial test of EU's credibility to making important strategic decisions, to resist the pressure of narrow interest groups and to create an additional stimulus to economic growth in the current member states. Although the EU enlargement and the implementation of the Lisbon goals (to make the EU the most competitive economy in the world) are often discussed separately, it could be stated that the successful handling of the enlargement would produce a significant push for the achievement of Lisbon goals. The Danish presidency of the second half of 2002 will have a major role in this.